Public Disclosure Authorized

Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 31-May-2024 | Report No: PIDIC00120

BASIC INFORMATION

A. Basic Project Data

Project Beneficiary(ies)	Operation ID	Operation Name	
Ethiopia	P181591	Ethiopia First Sustainable and Inclusive Growth Development Policy Operation	
Region	**Estimated Approval Date**	**Practice Area (Lead)**	**Financing Instrument**
EASTERN AND SOUTHERN AFRICA	25-Jul-2024	Macroeconomics, Trade and Investment	Development Policy Financing (DPF)
Borrower(s)	**Implementing Agency**		
Federal Democratic Republic of Ethiopia	Ministry of Finance		

Proposed Development Objective(s)

To support the Government of Ethiopia in its efforts to: (i) advance the restructuring of the financial sector and the liberalization of trade; (ii) promote fiscal sustainability and transparency; and (iii) support social resilience and climate action

Financing (US$, Millions)

Maximizing Finance for Development

Is this an MFD-Enabling Project (MFD-EP)? Yes

Is this project Private Capital Enabling (PCE)? Yes

SUMMARY

Total Financing	**1,500.00**

DETAILS

Total World Bank Group Financing	**1,500.00**
World Bank Lending	1,500.00

Decision

The review did authorize the preparation to continue

B. Introduction and Context

Country Context

1. **Ethiopia's state-led growth model generated high growth and social improvements.** Expansive public investments were central to the model, and were facilitated by an overvalued exchange rate, financial repression, debt financing, and extensive regulatory distortions. The model supported Ethiopia in becoming one of the fastest-growing countries between 2004-18 (average real growth of 10 percent). It helped accelerate access to infrastructure, services, and better living standards. Important results include one of the fastest reductions in rates of open defecation (63 percent), an expansion of proximate potable water access to 60 million people, a doubling of electricity access, and a 64 percent increase in child vaccinations. These advances reduced the national poverty rate from 39 to about 24 percent.[1]

2. **But these achievements came at a high cost.** The model is crowding out private investment, undermining external competitiveness, fueling inflation, and depleting external and fiscal buffers.[2] By 2019, public debt had nearly doubled, triggering a first public debt restructuring exercise in 2019. Financial repression, monetary deficit financing, and directed lending to SOEs contributed to misallocations of investments, structurally high inflation, and growing financial stability risks. Notably, high growth has not translated into enough productivity growth and job creation. The economy's structure has also remained broadly unchanged since 2004, and 70 percent of people remain reliant on agriculture for their livelihoods.

3. **Persistent shocks and inadequate policy responses triggered a debt default in late 2023.** Amid growing external imbalances and rising public debt, Ethiopia was hit by several shocks beginning in 2020, including the COVID-19 pandemic, the Tigray conflict, the war in Ukraine, and persistent droughts. Between 2020-23, growth slowed to 6.5 percent, while the poverty rate is estimated to have risen. In 2021, Ethiopia requesting debt treatment under the G-20 Common Framework due to rising external financing pressures and declining official assistance. To manage FX pressures, the government tightened already onerous current account and financial sector restrictions and increased mandatory FX surrender requirements to 70 percent.[3] As the tax-to-GDP ratio fell (now below 7 percent), the government has cut spending and severely limited wage increases and social safety net payments despite persistent double-digit inflation. As FX shortages increased, Ethiopia began accumulating bilateral debt arrears and eventually defaulted on its Eurobond coupon payment in December 2023.

4. **A humanitarian crisis, made worse by climate change, has compounded Ethiopia's challenges.** The Tigray conflict displaced over 20 million people and destroyed essential infrastructure and health services. Reconstruction cost estimates are US$20 billion. Continued conflict, interruptions to aid supplies, and the worst drought in 40 years have continued to fuel hunger and displacement. Results from a climate change risk screening suggest that Ethiopia is highly vulnerable to climate change. Climate change is expected to impose large, spatially concentrated, and growing costs on people and the economy, especially for households in the lowlands and the livestock industry.[4]

1 Ethiopia Poverty Assessment (2019).

2 Ethiopia Systematic Country Diagnostic Update (2024).

3 Foreign exchange surrender requirements to commercial banks were raised from 30 to 50 percent in September 2021 and further to 70 percent in January 2022. Over the same period, the maximum level of retention of foreign exchange for exporters was reduced from 45 to 20 percent.

4 Climate related average annual losses to GDP range from 1- 1.5 percent this decade, rising to 5 percent in the 2040s, and at the upper range of

5. **The government has initiated a new phase of reforms to reduce macroeconomic imbalances and revive growth.** In the last 18 months, monetary policy has been tightened, FX surrender requirements partially eased, retail fuel subsidies have been reduced, and SOE reforms to strengthen oversight and constrain their borrowing have continued. In addition, a Capital Markets Authority, a new deposit insurance program, and a new digital ID system were established. The government has reiterated its commitment to liberalize key sectors of the economy (retail, wholesale, logistics). Responding to growing costs from climate change, Ethiopia committed to adaptation and mitigation measures with the adoption of its Long-Term Low Emissions Development Strategy (LT-LEDS).

6. **Ethiopia's development agenda remains vast, and its economic transition will take time.** The business and investment environment require substantial reform to increase private sector entry and fair competition. Trade barriers remain significant; Ethiopia's trade-to-GDP ratio is the second lowest in the world, and it is not yet a member of the World Trade Organization (WTO). Significant infrastructure and human capital deficits are being worsened by declining fiscal space. A child born in Ethiopia today will be 38 percent as productive as compared to when she could enjoy a complete education and full health. SOEs remain inefficient despite consuming substantial resources. Addressing these issues depends on macroeconomic stability but also requires a wide range of complementary structural reforms.

Relationship to CPF

7. **This DPO is aligned with the current CPF and consistent with emerging priorities of a forthcoming Ethiopia Country Partnership Framework (CPF, FY2025-30).** It is also complementary to the World Bank Group's wider portfolio of engagement in Ethiopia. Ethiopia has an IDA portfolio of US$ 17 billion in active projects, several of which support actions that are complimentary to the reforms supported by the DPO series. The current IDA portfolio includes operations in a wide area of sectors including social safety nets, energy, finance, education, agriculture, land management, transport and trade logistics, water and sanitation, urban development, among others. A recently approved Power Sector Reform, Investment, and Modernization project (P176731) will support reforms in the energy sector. Moreover, a Governance Modernization Project supporting revenue mobilization is expected to be presented to the Board together with this DPO, while a planned Financial Sector Strengthening Project (FSSP) will support the modernization of financial sector governance and oversight.

C. Proposed Development Objective(s)

8. To support the Government of Ethiopia's efforts to: (i) advance the restructuring of the financial sector and the liberalization of trade; (ii) promote fiscal sustainability and transparency; and (iii) support social resilience and climate action.

Key Results

9. **This proposed DPO series supports the government in building foundations for more inclusive and sustainable growth.** Actions in this operation will help strengthen the financial sector, expand trading opportunities, increase fiscal transparency, efficiency, and sustainability, and enhance social resilience and climate action. These actions are expected to support Ethiopia in shifting towards a more inclusive and private sector led growth model while also strengthening protections for poor and vulnerable households during periods of economic adjustment. It also aims to strengthen opportunities for growth from more pro-poor sources, especially agriculture and trade, which could benefit some of the poorest people in Ethiopia.

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estimates, could push an additional 3.7 million people below the poverty line. Ethiopia Country Climate and Development Report (2024).

D. Concept Description

10. **This DPO series intends to (i) advance the restructuring of the financial sector and the liberalization of trade; (ii) promote fiscal sustainability and transparency; and (iii) support social resilience and climate action.** Pillar 1 actions would increase financial intermediation and liberalize trade by strengthening the legal framework for banking supervision; increasing competition in the banking sector; and expanding trading opportunities. Pillar 2 actions would mobilize tax revenues, expand e-procurement services, support a transition to electricity cost-recovery, and enhance public sector financial transparency. Pillar 3 actions would cushion the poor from the impact of reforms by expanding and improving social safety nets, enhance regulations for rural land and forest management, and incorporate climate considerations in public investment, all of which will help build resilience and generate climate co-benefits.

11. **The proposed operation series is aligned with the goals of the Paris Agreement.** The program is consistent with Ethiopia's climate commitments in the updated NDC, LT-LEDS, its earlier CRGE, and the findings of the 2024 CCDR. The reforms in this DPO advance important recommendations in the CCDR on enabling market signals to work for a more carbon efficient and climate-resilient economy. Financial sector and trade reforms that expand private investment and trade may increase GHG emissions. To mitigate this risk, this operation does not directly support any emission-intensive activities. It is also expected to reduce GHG emissions through (i) more sustainable land and forestry management (which generate 90 percent of Ethiopia's carbon emissions); (ii) energy sector financial sustainability that will reduce wasteful consumption, sustain Ethiopia's low-carbon energy generation investment strategy, and enable faster access expansions to renewable-sourced grid and off-grid electricity that reduce energy emissions from carbon-emitting alternative energy sources (wood, charcoal, diesel). The operation is also expected to contribute to climate change priorities through safety net expansions which are dominated by public works programs directly linked to climate adaptation priorities. Other prior actions are not likely to materially impact Ethiopia's GHG emissions or constrain low-carbon development. On adaptation and resilience goals, risks from climate hazards are not likely to have an adverse effect on the prior actions' contribution to the PDO for several prior actions (trade, safety nets) and will instead contribute positively to reducing climate risks (social safety nets, land and forest management, green procurement, ESIA and C-PIM in public investment). PAs that do not contribute directly to adaptation but also are not at risk from climate hazards include financial sector, energy sector, tax and fiscal transparency reforms. All prior actions of the proposed DPO program are assessed to be in alignment with the mitigation, adaptation and resilience goals of the Paris Agreement. Annex 6 provides a detailed review.

E. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

12. **This operation is likely to generate some negative poverty and social impacts.** Complementary reforms that are not part of this operation but support the underlying reform program are likely to have short-term negative poverty and social impacts. These impacts will be mitigated through expansions in social safety net assistance and the use of other budgetary programs to reduce impacts. Small negative or neutral impacts on households' welfare are expected from actions relating to trade, domestic revenue mobilization, and financial sustainability of the electricity sector. Measures relating to trade and land management could also have positive poverty impacts due to expanded agricultural market opportunities and more secure land rights.

Environmental, Forests, and Other Natural Resource Aspects

13. **The prior actions supported by this DPF series are expected to have positive or neutral impact on environment and natural resources**. Measures will have both direct benefits (e.g., land) and indirect benefits through institutional reforms that strengthen the consideration of environmental and climate-related issues in public financial processes.

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APPROVAL

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